AUSTRALIAN INVESTORS' HOME BIAS IN PORTFOLIO EQUITY INVESTMENT

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Abstract

This paper employs International Monetary Fund's high quality cross-border equity holdings dataset to investigate the determinants of home bias puzzle in the Australian context. This paper indicates that the share of destination countries' stock market that is invested in Australia and transaction costs have significant impact on the home bias puzzle. Capital controls and trade links also impact the home bias puzzle; however their effect is insignificant.

This paper also employs World Bank's governance indicators and other legal variables to investigate the phenomenon of home bias. Information asymmetries arising due to countries' regulatory and legal environment have significant impact on the home bias puzzle.

JEL Classifications: G11, G15, G30

Keywords: governance indicators, coordinated portfolio investment survey, rule of law, accounting standards

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1 Introduction

The traditional international capital asset pricing model (ICAPM) based on Sharpe (1964) and Lintner (1965) predicts that investors should hold equities from countries around the world in proportion to each market's capitalisation. However, empirical facts suggest that international portfolios are heavily biased towards domestic assets (French and Poterba (1991), Cooper and Kaplanis (1994), Tesar and Werner (1995), Ahearne, Griever and Warnock (2004)). This phenomenon is known as the "home bias puzzle". For instance, the actual domestic equity holdings of Australia and New Zealand in 2002 were 78.08% and 81.67% respectively, whereas the ICAPM benchmark percentages were 1.84 and 0.10 respectively.

The empirical investigation into the home bias puzzle is important for several reasons. First, globalization in general has increased capital mobility and foreign equity investments (Obstfeld, 1995). The identification of the relevance of capital market frictions promoting home bias give further insight into the future changes in portfolios. Second, the ongoing integration process in the European Union is likely to lead a change in its portfolio composition due to the joining of the Eastern European countries. The financial integration process will also affect the international portfolio equity composition. Third, the severe demographic changes in the European countries and Japan are likely to lead to a change in the capital flows. It is important for the estimation and prediction of future investments to know more about the effect of capital market frictions and the extent of capital mobility. Fourth, due to the lack of data on cross border holdings, the home bias puzzle is not fully explored. Due to lack

of accurate holdings data, researchers have greatly underestimated foreign portfolio positions, which greatly hampered the analysis of home bias. This paper fills the gap by employing the recent International Monetary Fund's (IMF's) Coordinated Portfolio Investment Survey (CPIS) dataset on bilateral equity holdings. Fifth, country specific studies on home bias, are either limited to US foreign equity holdings or focus on countries' foreign equity holdings not subdivided into country pairs. There are no studies focussing on portfolio equity home bias in the Australian context. This paper fills in the gap by empirically investigating the phenomenon of home bias in the Australian context, using high quality IMF dataset. This paper empirically investigates the home bias puzzle by analysing the role of direct barriers to investment viz. capital controls and transaction costs; indirect barriers based on information asymmetries including legal barriers; and control variables viz. trade links.

This paper is structured as follows: Section 2 provides literature review of the home bias puzzle. Section 3 outlines the empirical framework and model. Section 4 refers to the data and describes the various explanatory variables employed in the model. Section 5 presents stylized facts about the home bias puzzle. The results are presented in section 6 and finally, section 7 concludes.

2 Literature Review

Black (1974) and Stulz (1981) develop a two country capital market equilibrium model where there are barriers to cross border investment and these barriers can be considered as tax on net foreign investment. This tax represents various kinds of barriers to international investment such as direct controls on the import or export of capital, possibility of expropriation of foreign holdings, reserve requirements on bank deposits

and other assets held by foreigners, restrictions on the fraction of business that is owned by foreigners. It may also include barriers due to information asymmetries i.e. unfamiliarity of residents of one country with the stock markets of other countries. Merton (1987) develops a model where investors hold stocks that they know. In this model, investors think that the risk of stocks they do not know is extremely high. Accordingly, the investors may overweight domestic stocks. Cooper and Lessard (1981) develop an international capital market equilibrium model which allows for differential taxes on foreign investment depending on the country of investment and the origin of investor. They obtain unique solutions for taxes under extreme assumptions that taxes depend on the country of investment, or on the origin of investor. Cooper and Kaplanis (1994) find that hedging against inflation risk cannot explain the home bias.

Several papers consider the effect of indirect barriers i.e. information asymmetries on equity investment and home bias. French and Poterba (1991), for instance, find that information asymmetry can generate the same observed portfolio patterns as if investors expect the domestic returns to be several hundred basis points higher than the returns in foreign markets. Gehrig (1993) uses a noisy rational expectations model to investigate the effect of asymmetric information between domestic and foreign investors. Investors observe noisy signals with different degrees of precision. The domestic investors receive signals of future returns that are more precise. The investors remain incompletely informed, even in equilibrium. Domestic bias arises from better investor information about domestic stocks. Thus, on average foreign investments appear to be more risky. Hasan and Simaan (2000) derive the premium that an investor is willing to pay to buy the full information of the mean return vector and show that

rational investors prefer home country dominated portfolios over diversified portfolios if the variability of estimation errors far exceeds the variability of the mean return vector.

There are several papers investigating the home bias puzzle related to individual countries viz. Japan (Kang and Stulz (1997)), Sweden (Dahlquist and Robertsson (2001)), Korea (Kim and Wei (2002)) and United States (Ahearne et al (2004), Dahlquist et al (2003)). But absent from these is a study related to home bias in the Australian context. This paper fills in the gap by empirically investigating the home bias puzzle in the Australian context.

3. Modelling Home Bias

This paper employs a model which is derived from Cooper and Kaplanis (1986). The model is based on the presumption that investors face both explicit costs (transaction fees, taxes, commissions, and the costs of gathering information) and implicit costs (extra risk of expropriation and information gathering costs incurred by foreign investors in investing abroad). This paper employs the following empirical specification,

$$BIAS_{ij,t} = \alpha + \beta X_j + \varepsilon \qquad (1)$$

where

$BIAS_{ij,t}$ is the degree of country i's investors' home bias against country j i.e. the deviation from ICAPM benchmark defined as one minus the ratio of the share of foreign equities in the source country and world portfolios. X_j is a vector of independent variables that includes country j's investment share of its market

capitalisation in country i, $INV_{j,t}$; trade between country i and j, *Trade*; index of capital control for the country j, $Rstrict_{j,t}$; $W_{j,t}^{theor}$ is the optimal share of investment in the ICAPM with perfect markets; *Tran* is the transaction cost that country i has to incur inorder to invest in country j; legal indices based on La Porta et al (1998) and Kaufmann et al (2003).

4 Data Description

One of the major problems in the home bias research has been relatively poor quality of cross border holdings estimates. In the past, the cross border holdings were estimated using accumulated capital flows and valuation adjustments (Tesar and Werner (1995)). Warnock and Cleaver (2002) show that capital flows data are ill suited to estimate bilateral holdings. This paper employs the International Monetary Fund's (IMF's) Coordinated Portfolio Investment Survey (CPIS) dataset on bilateral equity holdings for the years 2001 and 2003. CPIS reports data on foreign portfolio asset holdings (divided into equity, long term debt, and short term debt) by residence of issuer. In 1997, IMF conducted the first CPIS wherein 29 countries participated; the next survey was conducted in 2001 wherein 69 countries participated and now CPIS is being conducted on an annual basis.

The variables related to the empirical specification of the model in equation (1) include investment, trade, optimal investment share in ICAPM, transaction cost, La Porta et al (1998) legal indicators and Kaufmann et al (2003) governance indicators. These variables are described below:

(a) Investment

$INV_{j,t}$ is the share of the country j's market capitalisation that is invested in country i. This variable is expected to have negative impact on $BIAS_{ij,t}$. This implies that the greater the equity investment of country j in country i, the lesser will be the deviation from the benchmark CAPM. This variable is computed using the data on bilateral equity holdings from CPIS and the data on stock market capitalisation from the International Federation of Stock Exchanges (FIBV).

(b) Trade

$Trade$ is the average of imports and exports normalised by the destination country's GDP. Investors are better able to attain accounting and regulatory information on foreign markets through trade. Consequently, investors may be inclined to hold the stocks of foreign companies with whose products they are most familiar. This variable is expected to have negative impact on $BIAS_{ij,t}$. The data on imports and exports is taken from IMF's Direction of Trade Statistics and GDP data is from World Bank's World Development Indicators.

(c) $W_{j,t}^{theor}$

$W_{j,t}^{theor}$ is the optimal share of investment in the ICAPM with perfect markets. $W_{j,t}^{theor}$ is the ratio of market capitalization of country j to world market capitalization, at time t. The market capitalisation data is from the International Federation of Stock Exchanges (FIBV).

(d) Capital Control:

$Rstrict_{j,t}$ is based on the Miniane (2004) capital account measures. This index is expected to have positive impact on Australian investors' home bias in portfolio equity investment against destination countries.

(e) Transaction Cost

$Tran$ is a measure of transaction costs, derived from Elkins-McSherry Co. Elkins-McSherry Co. receives trade data on all global trades by institutional traders and computes measures of trading costs. The trading cost data comprises of three cost components viz. commissions, fees and market impact costs. This paper takes into account the total cost comprising of all the three cost components for the year 2001. Investors would underweight high transaction cost countries' in their portfolios. Therefore, this variable is expected to have positive impact on $BIAS_{ij,t}$.

(g) Legal Variables

This paper also investigates the impact of legal indices (La Porta et al (1998) and Kaufmann et al (2003)) on $BIAS_{ij,t}$. It explores the role of information assymetries that arise from differences in accounting standards, disclosure requirements, and regulatory environments across countries. These legal indicators are expected to have negative impact on $BIAS_{ij,t}$.

5 Home Bias Puzzle: Some Stylized Facts

Table 1 compares the actual share of domestic equities held by Australians in other countries with the benchmark share in the world portfolio as per ICAPM model. Actual portfolio share is the foreign equity holdings of Australia in other countries relative to Australia's total holdings of foreign and domestic equities. Theoretical portfolio share

is country's market capitalization in the world market capitalization. The table indicates that Australia's actual portfolio share is the highest in US (9.94%) followed by UK (1.56%), Netherlands (0.94%), Japan (0.98%), France (0.67%), Germany (0.44%), Hong Kong (0.37%), Switzerland (0.31%) and then, the remaining countries of the world. The comparison of the actual holdings to the benchmark shares gives an indication of the degree to which Australian investors' underweight different foreign countries. Australian holdings are less than those predicted by ICAPM. There is a significant amount of variation in values across countries. The ratio is 0.42 for Netherlands indicating that Australian investors' holding of stocks from Netherlands at end-2001 was 42 percent of what traditional portfolio theory would have predicted. The degree of underweighting is more severe against countries like Korea and Malaysia, where Australian investors hold 2 percent of the shares predicted by traditional ICAPM levels.

Figure 1 presents Australia's home bias measure for 22 foreign countries. The measure of Australian investors' home bias against each country is constructed as one minus the ratio of actual to benchmark holdings. The bias measure varies from 0.58 for Netherlands to 0.98 for Malaysia.

Figure 2 illustrates the plot of countries' share of portfolio investment in Australia as compared to countries' market capitalisation versus Australia's equity investment home bias against those countries'. New Zealand has a high share of portfolio equity investment in Australia, as compared its market capitalisation. On the other hand, Korea and Malaysia have a low share of portfolio equity investment in Australia as compared to their stock market capitalisations. Australia's degree of home bias against

New Zealand is lower as compared to those of Korea and Malaysia. A striking feature of the pattern in Figure 2 is a negative correlation between a country's propensity to invest in Australia and the degree of bias.

Figure 3 presents countries' trade share in Australia normalized by countries' GDP versus Australia's homebias against countries' equity investment. For example, New Zealand has close geographical proximity and close affinity in terms of culture, language, legal origin, regulatory environment etc. with Australia. Therefore, New Zealand has high trade share in Australia and consequently, Australian investors are better informed about New Zealand's investment scenario through its trading relations. Australia has a low degree of equity home bias against New Zealand.

Figure 4 illustrates the plot of capital controls versus bias. Malaysia has high degree of capital controls as compared to United Kingdom and United States. Therefore, Australian investors may underweight Malaysia as compared to United Kingdom and United States in their portfolio equity. Australia has high degree of homebias against Malaysia as compared to United Kingdom and United States.

Figure 5 illustrates the plot of relative transaction cost versus bias. Transaction costs are plotted relatively to Korea's transaction cost, which has been adjusted to 1. The relative transaction cost of US is very low as compared to Korea. Australian investors would underweight countries' with very high transaction costs in their portfolio equity holdings.

6 Empirical Results

Tables 2 to 5 illustrate the regression results for the model associated with equation (1). The source country is Australia and the host countries are Austria, Brazil, Chile, China, Hong Kong, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Korea, Malaysia, Netherlands, New Zealand, Norway, Peru, Philippines, Poland, Portugal, Russian Federation, Singapore, South Africa, Spain, Sweden, Switzerland, Thailand, Turkey, United Kingdom, and United States.

In Table 2, column (1), the INV_j variable is negative and significant implying that greater the destination countries equity investment in Australia, the lesser will be Australia's homebias against these countries. 100 percent increase in INV_j leads to a decrease in Australian investors' home bias by about 1.8 percent. In column (2), capital control variable, $Rstrict_{j,t}$ is added. $Rstrict_{j,t}$ appears positive but insignificant. The positive sign of $Rstrict_{j,t}$ implies that greater the destination countries' restrictions on their cross-border equity investments in Australia; greater will be Australia's degree of home bias against the destination countries. INV_j variable is negative but it looses significance. In column (3), $Trade$ variable is added, which appears to be negative but insignificant. Negative sign of $Trade$ variable implies that greater the trading activities between destination countries and Australia, the lesser will be Australia's portfolio equity investment home bias against these countries. INV_j and $Rstrict_{j,t}$ variables have the same sign as in column (2) and both are insignificant. The results in column (3), indicate that INV_j, $Rstrict_{j,t}$ and $Trade$ variables, taken together do not have any significant effect on the Australia's home bias. In column (4), there are two dependent

variables viz. INV_j and $Tran$. INV_j is negative and significant implying that greater the host countries investment in Australia, the lesser will be Australia's equity home bias against these countries. $Tran$ appears to be positive; however, it is insignificant. This implies that greater the host countries transaction costs, the greater would be Australian investors' equity home bias against these countries. Column (5) adds variable TC, the interaction term of $(1-Tran)$ and INV_j. INV_j is negative and significant implying that greater the host countries investment in Australia, the lesser will be Australia's home bias against these countries. $Tran$ is positive and significant implying that greater the host countries transaction costs, the greater would be the Australian investors' equity home bias against these host countries. TC is positive and significant, implying that countries having high transaction costs are less underweight in Australian portfolios. Overall, results in column (5) indicate that investing in Australian stock market reduces home bias through reduced transaction costs.

Table 3 explains the changes in home bias from 2001 to 2003. The paper regresses the change in $BIAS_{ij,t}$ on the initial level of $BIAS_{ij,t}$, and the initial levels of and changes in INV_j and W^{theor}. $BIAS_{ij,t}$ is negative; however it is insignificant. INV_j is negative and significant. This implies that countries that were underweighted by the Australian equity investors in 2001 tended to see increases in the equity investments in 2003. W^{theor} is positive; however it is insignificant. Changes in INV_j and W^{theor} have no significant effect on the changes in home bias from 2001 to 2003.

Table 4 illustrates the impact of La Porta et al (1998) variables on $BIAS_{ij,t}$ in the Australian context. INV_j variable is negative and significant, throughout implying that

greater the destination countries equity investment in Australia, the lesser will be Australian investors' homebias against these countries. Individually, the index rule of law (RL) is negative but insignificant; and the index efficiency of judicial system (EFF) is both negative and significant. Column (3) indicates that 100 percent increase in the destination countries efficiency of judicial system leads to 2.2 percent decrease in Australia's equity home bias against these countries. Overall the results imply that Australian investors' home bias will decrease against those destination countries that have efficient judicial system and high tradition of law and order.

Table 5 presents the regression results that show the impact of Kaufmann et al (2003) indicators on home bias in the Australian context. On individual basis, Kaufmann et al (2003) governance indicators viz. Rule of Law (RL), Control of Corruption (CC), Government Effectiveness (GE) and Regulatory Quality (RQ) have negative and significant impact on home bias in the Australian context. Regulatory Quality (RQ) indicator has the greatest impact on home bias. 100 percent increase in destination countries regulatory quality environment leads to a decrease in Australia's equity home bias against destination countries by about 12 percent. Column (5) presents the results by taking the average of Kaufmann et al (2003) indicators. A 100 percent increase in AVE variable, leads to a decrease in Australia's equity home bias against destination countries' by about 8.5 percent.

7 Conclusion

This paper employs IMF's high quality CPIS dataset to investigate the determinants of home bias puzzle in the Australian context. The data itself indicates some interesting stylized facts about home bias puzzle.

Results indicate evidence of a decrease in Australia's home bias as the share of destination countries stock market that is invested in Australia increases. Capital controls are found to have a positive but insignificant impact on the home bias. Trade links are found to have a negative but insignificant impact on home bias; implying that trade alleviates certain information asymmetries in terms of familiarity with the financial and legal environment of the countries; cultural barriers etc. Transaction costs are positive and significant; implying that Australian investors underweight the high transaction cost countries in their portfolios leading to greater Australia's bias against these countries.

This paper also investigates the impact of La Porta et al (1998) legal variables and Kaufman et al (1999) governance indicators on homebias. Australia has low degree of homebias against those countries that have an efficient judicial system and high tradition of law and order. Kaufman et al (2003) indicators related to government effectiveness, regulatory quality, rule of law and control of corruption have significant and negative impact on Australia's home bias against equity investment in the destination countries.

The main purpose of this paper is to analyse causes for the home bias puzzle and to derive implications from these findings for economic policy. This paper finds that the barriers to the free mobility of equity can arise from two main sources. First, policy measures in the form of capital controls can cause barriers to free equity flows. Second, even if policy induced barriers to equity flows have been lifted, there remain substantial economic or market inherent barriers. These barriers tend to remain

relevant and to affect the way in which financial systems operate and integrate even if economic policy has reduced regulatory barriers to entry. The asymmetries in information between domestic and foreign investors, which can arise from differences in regulatory environments, are of primary importance. The market inherent barriers due to fixed costs of market entry including transaction costs are also important.

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Table 1: Australia's portfolio equity investment

Countries	Actual (%) portfolio share 2001	Benchmark (%) as per ICAPM 2001	Actual over Benchmark
Denmark	0.04	0.34	0.11
Finland	0.09	0.77	0.11
France	0.67	4.61	0.14
Germany	0.44	4.02	0.10
Greece	0.01	0.31	0.03
Hungary	0.00	0.03	0.07
Hong Kong	0.37	1.90	0.19
Ireland	0.05	0.28	0.17
Italy	0.18	2.09	0.08
Japan	0.98	9.84	0.09
Korea	0.01	0.44	0.02
Malaysia	0.01	0.47	0.02
Netherlands	0.94	2.22	0.42
New Zealand	0.01	0.07	0.14
Norway	0.02	0.27	0.07
Singapore	0.11	0.46	0.23
South Africa	0.05	0.31	0.16
Spain	0.13	1.44	0.09
Sweden	0.09	0.93	0.09
Switzerland	0.31	2.35	0.13
UK	1.56	8.75	0.17
US	9.94	54.86	0.18

Source: Foreign equity investments from the IMF's CPIS, market capitalizations from FIBV

Table 2: Australia's Home Bias Regression Results

	(1)	(2)	(3)	(4)	(5)
$INV_{j,t}$	-0.018	-0.169	-0.154	-0.01	-0.07
	(-2.775)**	(-1.068)	(-0.974)	(-1.85)***	(-4.04)*
$Rstrict_{j,t}$		0.047	0.103		
		(0.599)	(0.941)		
Trade			-0.015		
			(-1.218)		
Tran				0.00	0.00
				(1.36)	(1.74)***
TC					0.10
					(2.99)*
Constant	0.854	0.867	0.861	0.77	0.75
	(36.723)*	(23.806)*	(22.452)*	(11.00)*	(9.71)*
Adj R^2	0.01	0.08	0.05	0.03	0.02
Obs	37	37	37	37	37

Note: ***,** and * indicate significance at the 1%, 5% and 10% levels, respectively. White corrected t-statistics in parenthesis.

Table 3: Change in Australia's Home Bias from 2001 to 2003

	(1)
*Bias*2001	-0.24
	(-0.80)
*INV*2001	-0.06
	(-2.73)**
W^{theor} 2001	0.00
	(0.13)
ΔINV2001	0.00
	(0.20)
ΔW^{theor} 2001	0.01
	(0.51)
Constant	0.26
	(0.93)
Adj R^2	0.39
Obs	37

Note: ***,** and * indicate significance at the 1%, 5% and 10% levels, respectively. White corrected t-statistics in parenthesis.

Table 4: Australia's Home Bias using La Porta et al (1998) indicators

	(1)	(2)	(3)	(4)
$INV_{j,t}$		-0.013		-0.012
		(-1.816)***		(-1.843)***
ROL	-0.016	-0.014		
	(-1.226)	(-0.990)		
EFF			-0.022	-0.019
			(-1.840)***	(-1.522)
Constant	0.984	0.970	1.036	1.021
	(9.074)*	(8.726)*	(10.898)*	(10.256)*
Adj R^2	0.02	0.00	0.05	0.03
Obs	37	37	37	37

Note: ***,** and * indicate significance at the 1%, 5% and 10% levels, respectively. White corrected t-statistics in parenthesis. *ROL* : Rule of Law. *EFF* : Efficiency of judicial system.

Table 5: Australia's Home Bias using Kaufmann et. al (2003) Indicators

	(1)	(2)	(3)	(4)	(5)
GE	-0.090				
	(-2.114)**				
RQ		-0.122			
		(-1.987)***			
RL			-0.069		
			(-1.798)***		
CC				-0.061	
				(-2.144)**	
AVE					0.085
					(-1.767)***
Constant	0.98	1.01	0.94	0.93	0.95
	(17.46)*	(13.13)*	(19.20)*	(26.91)*	(17.27)*
Adj R^2	0.18	0.17	0.08	0.13	0.11
Obs	37	37	37	37	37

Note: ***,** and * indicate significance at the 1%, 5% and 10% levels, respectively. White corrected t-statistics in parenthesis. GE : Government Effectiveness. RQ : Regulatory Quality. RL : Rule of Law. CC : Control of Corruption. AVE : Average of GE, RQ, RL and CC.

Fig 1: Country Bias in Australia's Equity Holdings

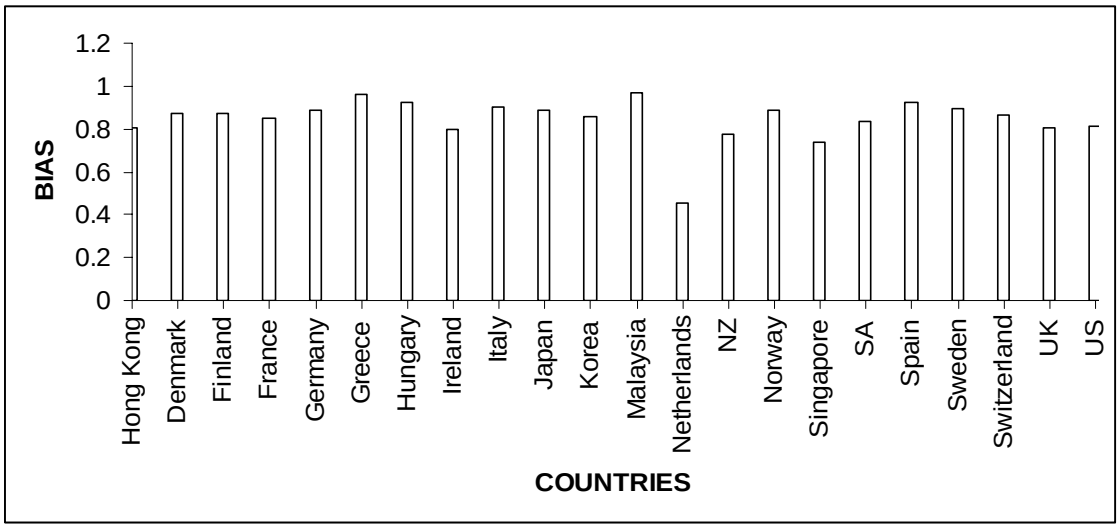

Fig 2: Relation between Share of Foreign Market's Investment in Australia and Australia's Bias

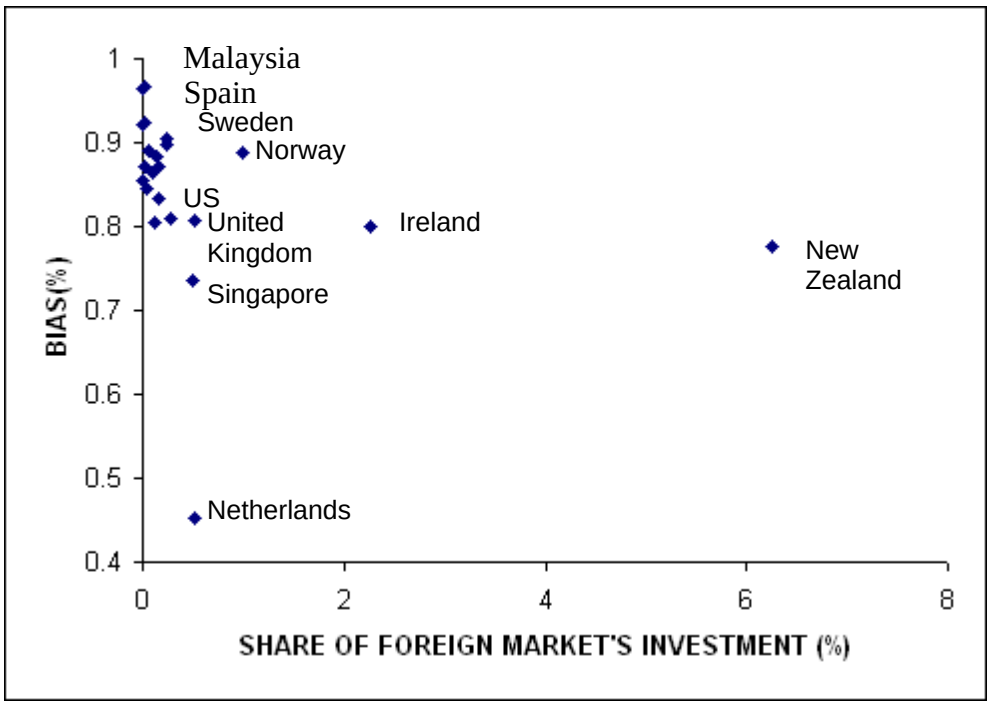

Fig 3: Relation between Trade and Australia's Bias

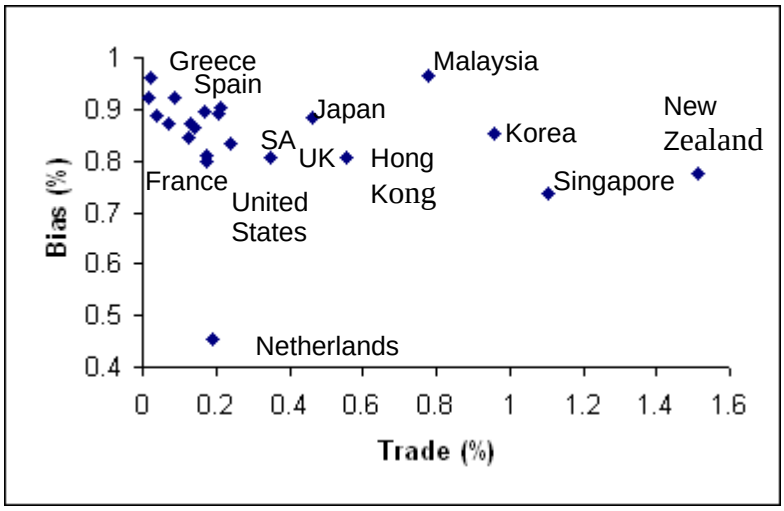

Fig 4: Relation between Capital Control and Australia's Bias

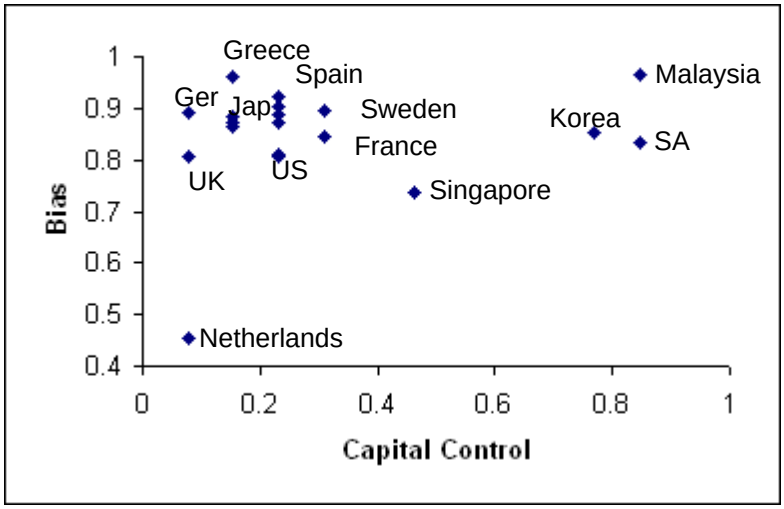

Fig 5: Relation between Relative Transaction Costs and Australia's Bias